Association of Financial Mutuals

Corporate Governance Report 2019

August 2019

Introduction

This is the latest report from AFM on corporate governance in the mutual insurance sector. It draws on compliance returns from our members, showing their stated levels of compliance during 2018 with the Annotated Corporate Governance Code for Mutual Insurers.

The primary purposes of this report are to enable our members to benchmark their performance against their peers, as well as to provide an overview to Treasury and the financial regulators on standards of governance amongst members of AFM.

This is our final report on governance assessed against standards designed primarily for listed companies, as per the Financial Reporting Council's UK Corporate Governance Code. In December 2018 we launched a new AFM Corporate Governance Code, intended to provide a better fit with the business model of our members. For more, see: http://www.financialmutuals.org/governance/.

Contents

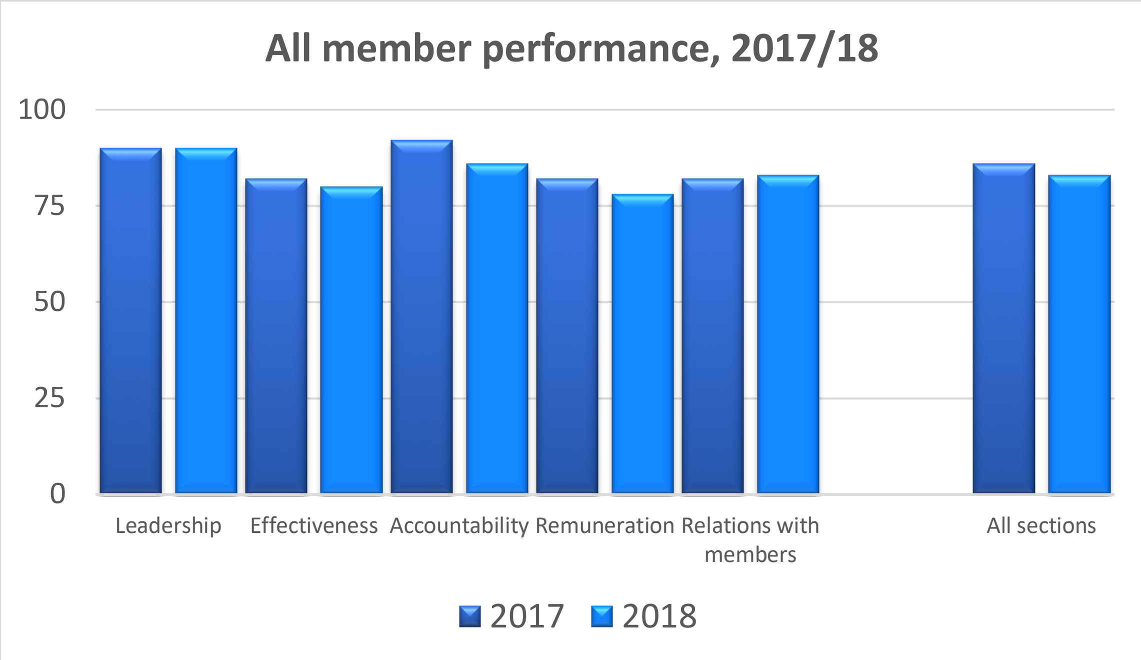
About AFM

The Association of Financial Mutuals (AFM) was established on 1 January 2010. Financial Mutuals are member-owned and not-for-profit organisations, many of whom have operated for over 100 years, and the nature of their ownership, and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers.

AFM currently has 50 members and represents mutual and not-for-profit insurers, friendly societies and discretionary mutuals in the UK and Ireland. Between them, UK mutuals manage the savings, protection and healthcare needs of over 30 million people, and have annual premium income of around £16 billion. For more, go to www.financialmutuals.org.

Overall results

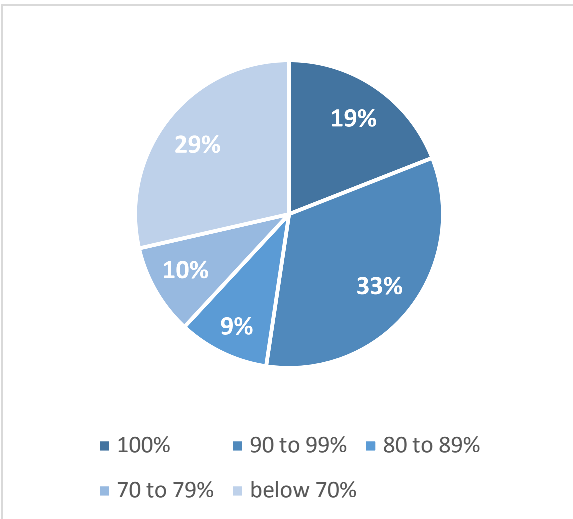
The chart below shows performance by all members across the five sections of the Code, and overall, comparing 2018 results against 2017:



As the chart shows, overall results fell a little between the two years. One contributory factor was that the report for 2018 compliance was completed by all 42 eligible members of AFM (see Annex 3). This compares to 37 in 2017 and as a result, a number of organisations that had not completed the exercise in the past, and those who were unable to complete the exercise the previous year due to compliance or business change reasons, did so in 2018.

There were therefore a number of organisations for whom the process was new and the requirements different. When those were taken out, of the 37 that completed both returns, the stated level of compliance was almost unchanged, at 85.5% versus 85.8% in 2017.

This chart shows the distribution of performance by companies, based on the proportion of the 54 Code Provisions that they complied with.



In 2018, eight organisations reported that they complied with all 54 Provisions, compared to five the previous year. The eight were: British Friendly, Cornish Mutual, Dentists' Provident, DG Mutual, Kingston Unity, Scottish Friendly, Tees Mutual and Foresters Friendly. Over half of members complied with more than 90% of the Provisions.

There were a significant minority of members that complied with less than 70% of code provisions. This included all of those that had not reported in 2017 and for whom therefore the code was relatively unfamiliar, as well as a number of members who were very small (non-directive insurers with premiums and assets below the threshold of the Solvency 2 Directive) and for whom many of the standards designed for the largest listed companies are least relevant.

To illustrate, against an overall average rate of compliance of 83% in 2018, the 12 non-directive firms achieved an average of 66%, compared to an average for Solvency 2 firms of 89%.

Detailed breakdown of code provisions

Section A: Leadership

This section of the Code focuses on how well the board takes collective responsibility for the long-term success of the company. There are eight provisions in this section, and they continue to attract the highest scores overall:

SECTION A	all companies	directives	non-directives
2018	90%	92%	85%
2017	90%	93%	82%

Most of the provisions in this section showed strong levels of compliance, and whilst none achieved 100% compliance, there were a number where a single organisation highlighted procedural actions were omitted in 2018, or were being introduced in the future.

More notable cases on non-compliance included:

- In 17% of organisations, the Chairman was not deemed independent on appointment (code provision A.3.1). In many cases the stated explanation was that the Chair was a long-serving member of the Board.
- 14% of firms had not appointed a Senior Independent Director (A.4.1), though in many cases this was because as a not-for-profit organisation, policyholders could raise issues with the deputy chair (non-directives could also elect not to comply with this provision).
- In 11% of organisations, the NEDs did not meet during the year without either the executive, or the Chair, present (A.4.2). The explanations given did not clearly suggest what alternative mechanism there was for critically appraising the performance of the executive and/ or chair.

Section B: Effectiveness

This section considers the balance of skills, experience, independence and knowledge of the Board, as well as appointments to the Board and the effective operating of it. This is the most extensive section in the Code, with 17 provisions. This section witnessed a reduction in compliance in 2018:

SECTION B	all companies	directives	non-directives
2018	80%	87%	59%
2017	82%	89%	65%

This section witnessed significant differences in compliance between directive and non-directive organisations, and no single provision achieved 100% compliance. The provisions with low levels of compliance included:

- Nominations Committees were not always in place or active in the year, with size of organisation or lack of turnover of the board cited as explanation (CPs B.2.1, B.2.2 and B.2.4).
- In 24% of organisations, NEDs were not appointed for a specified term (B.2.3). This was an issue for newer members of AFM in particular but not exclusively. In 29% of organisations, the board's assessment of the suitability of a director seeking re-election was not provided with election papers (B.7.2).
- The annual report did not cover board review in a third of cases, and a similar number did not undertake regular externally facilitated board evaluation (CPs B.6.1 and B.6.2).

See also the section on board structure.

Section C: Accountability

The principles in this section relate to how well the Board understands the financial prospects of the organisation and the nature of the risks it is exposed to. Overall performance across the 14 provisions was lower than the previous year:

SECTION C	all companies	directives	non-directives
2018	86%	95%	63%
2017	92%	96%	83%

Organisations closely adopted requirements for explaining their strategy and going concern in the report and accounts (section C.1), and there were few exceptions on how the principal risks were managed (section C.2). There was however a significant reduction in compliance in section C.3, which focuses on the work of the audit committee, with non-directives in particular less likely to comply. Amongst provisions with lower levels of compliance were:

- A quarter of organisations either have no separate audit committee, or do not have a sufficient number of independent NEDs (C.3.1). This was the case in a number of non-directives, for whom the main board retained responsibility.
- As a result, a number of other criteria were not met, including that the annual report did not set out the work of the audit committee in a quarter of cases (C.3.8), and in 19% of cases, the basis for monitoring internal audit was not apparent (C.3.6).

Section D: Remuneration

This section focuses on the levels of remuneration as well as the policy for fixing remuneration packages. Results in this section, which has nine provisions, fell back from 2017, particularly for non-directives:

SECTION D	all companies	directives	non-directives
2018	78%	87%	54%
2017	82%	88%	69%

This section traditionally attracts lower levels of compliance, as many AFM members do not have an executive bonus scheme, or arrangements are very limited. Non-directives are invited not to apply some aspects of this section.

- Overall, 16 of 42 organisations do not provide performance-related pay for executives, and a further 3 provided very limited awards that they considered did not require clawback arrangements (D.1.1).
- A third of organisations did not have a remuneration committee (section D.2) and this role was discharged by the full Board.

Section E: Relations with members

This section relates to the dialogue with members and the actions taken to encourage participation in the Annual General Meeting. There are six provisions in this section, which witnessed an overall improvement in results:

SECTION E	all companies	directives	non-directives
2018	83%	87%	70%
2017	82%	87%	69%

This section was excluded by most-not-for-profits members, since their business model means that customers do not generally attain membership rights. Also, amongst some friendly societies there is a delegate system of democracy, with individuals nominated to represent all members at the AGM, and non-directives can disapply some aspects of the section. Hence, whilst member democracy is a core aspect of a functioning mutual, the results of this section are ambiguous.

- In 8 of 26 relevant organisations, the basis for the chair and NEDs to engage with members was restricted to the AGM (E.1.1 and E.1.2).

Within the questionnaire, we ask relevant members to report on the number of members voting at the AGM (excluding not-for-profits and delegate societies). Across 24 organisations, 3.0% of members on average voted at the AGM. This was a reduction from 3.4% in 2017, though the numbers are complicated by the status of Child Trust Fund accountholders in some friendly societies, who are unable to vote at the AGM until they reach the age of 18. Two organisations achieved an AGM turnover of 10%, whilst amongst the 8 relevant non-directives, many of whom do not provide proxy voting, the average turnout was 1.5% (compared to 3.2% amongst directive mutuals).

The use of explanations and narrative reporting more generally

As previously stated, 8 organisations indicated that they had fully complied through 2018 with all 54 provisions in the Code. For the remainder, it was necessary to provide an explanation which set out the reasons why the organisation had either decided not to comply, or to set out how alternative arrangements achieved a similar outcome.

In total, we observed 319 explanations, compared to 1,783 provisions fully complied with. This equates to 7.7 explanations per organisation on average, compared to 6.8 in 2017. Amongst many organisations, the care taken to set out a clear rationale was very encouraging, with a careful consideration of the arrangements made, either to address the issue differently or to amend processes in future years. We do though continue to see frequent reference to scale in explanations, without setting out why size prevented a firm complying, or what alternative approach is taken.

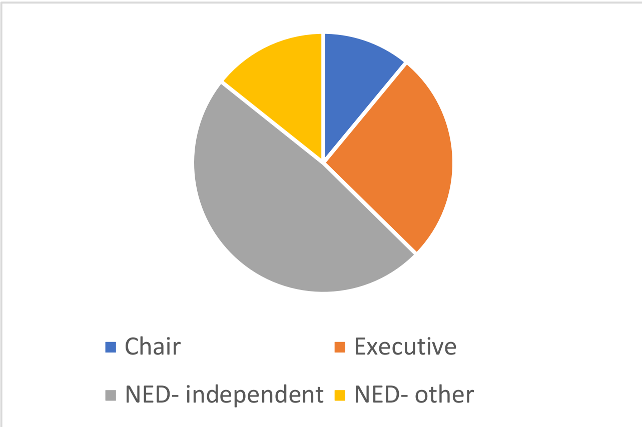
More generally, the format of report and accounts continue to evolve, with greater focus evident on improving the clarity and understandability of the document. Many sets of accounts run to over 60 pages, and include a thorough explanation of the business and its strategy, as well as its corporate governance arrangements and financial performance. The non-financial information is given much more prominence today, reflecting the need to engage effectively with a wider group of stakeholders, many of whom take at least as much assurance from the way a firm is managed than they do its key financial outcomes.

Directive organisations are required to publish a Solvency and Financial Condition Report to similar timescales to the report and accounts, and whilst the SFCR is more technical, there is evidence of cross-fertilisation between the two reports. For example, there is now more evidence to support the narrative in the report and accounts.

Board structure

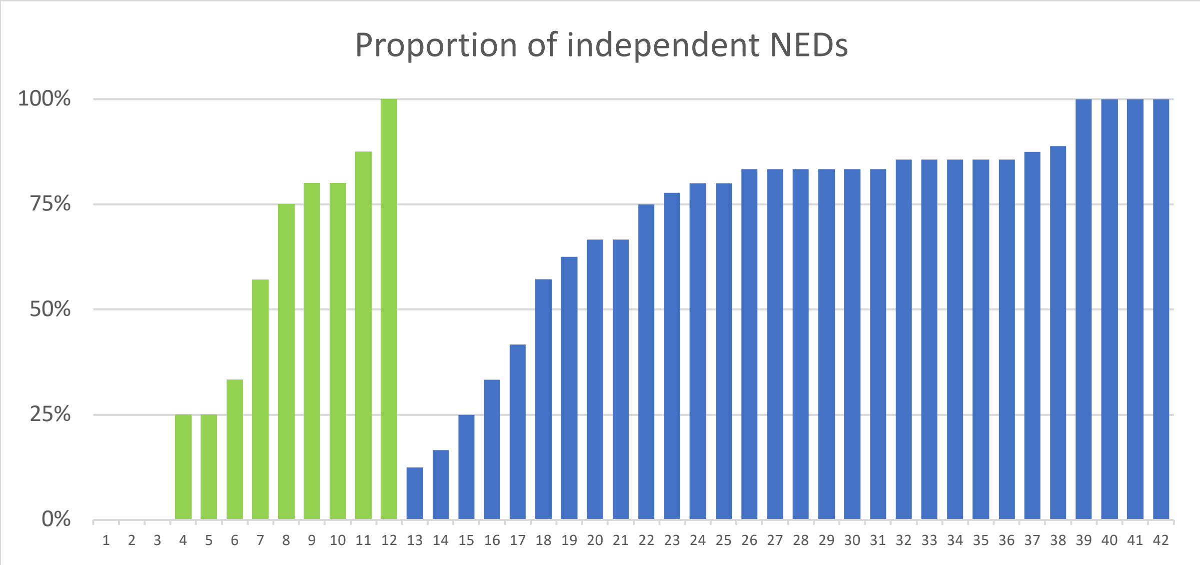
The average size of a board at the end of 2018 was 8.8, compared to 8.9 in 2017 and 9.1 in 2016. The range was between 5 directors and 14.

As well as reducing in size, the balance of the Board is continuing to shift, with an increase in executives (2.4 on average versus 2.1 in 2017), compared to non-executives (6.4 at end of 2018, from 7 at end of 2017).



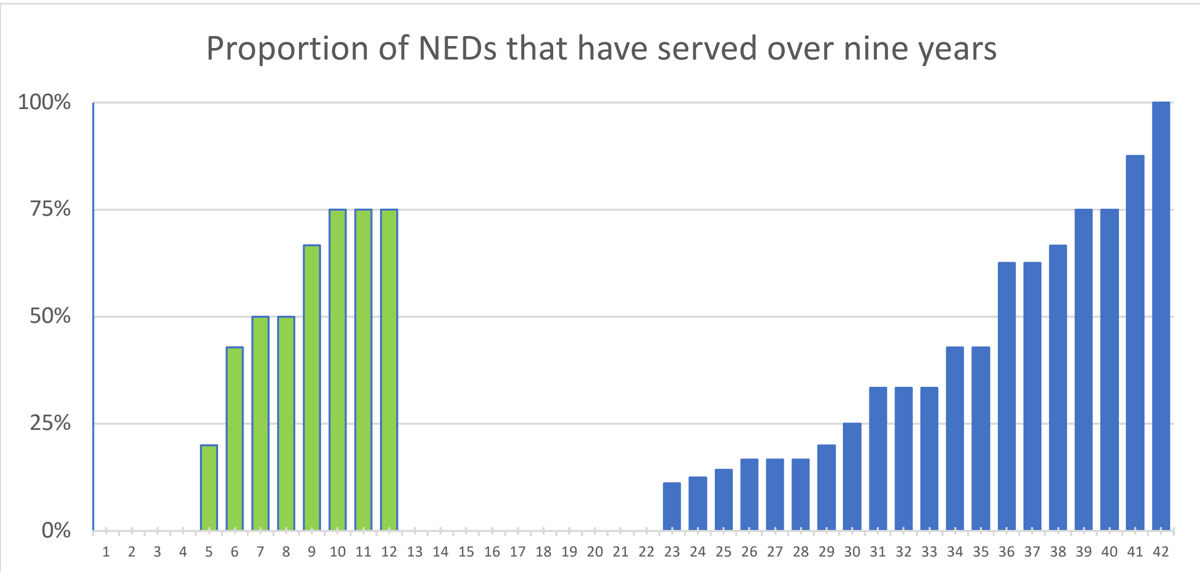
Amongst NEDs, the number defined as independent across the 42 organisations was 184 at the end of 2018, compared to 198 at the end of 2017.

Regulatory rules expect a half of NEDs are determined to be independent (two in non-directives). As the chart below shows, the proportion of NEDs that are independent varies significantly across organisations, and most organisations comfortably exceed the minimum expected levels. The chart indicates that generally non-directives (in green) have attained similar levels of independence to directives (in blue); nonetheless, in three non-directives there were no independent NEDs at the end of 2018.



Our questionnaire also asked organisations how many NEDs had served more than nine years. Across the 42 organisations, 30% of NEDs have served at least nine years; the 80 individuals compared with 26 across the entire FTSE250 according to Cranfield Business School.

In general, there was an inverse relationship between the regularity of elections and the degree to which the board has appraised the suitability of directors for re-election, and the number of long-serving directors. The chart below shows that again the picture varies significantly across organisations- with many, both directive and non-directives, with no NEDs having served more than nine years.



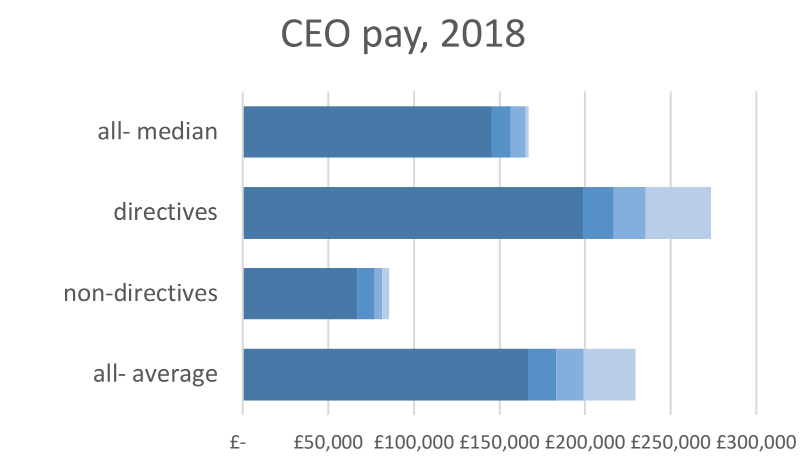
Having a large proportion of long-serving board members sets, within the Code, a higher expectation that those directors are elected annually, and that for those deemed independent, a stronger test is applied that they meet the conditions for independence, and that they continue to add value to the board.

As stated above, not all organisations had a separate audit and remuneration committee. Of those that did, the median numbers on the committees were: audit: 4 (including three independent NEDs); remuneration: 3 (3 independent NEDs).

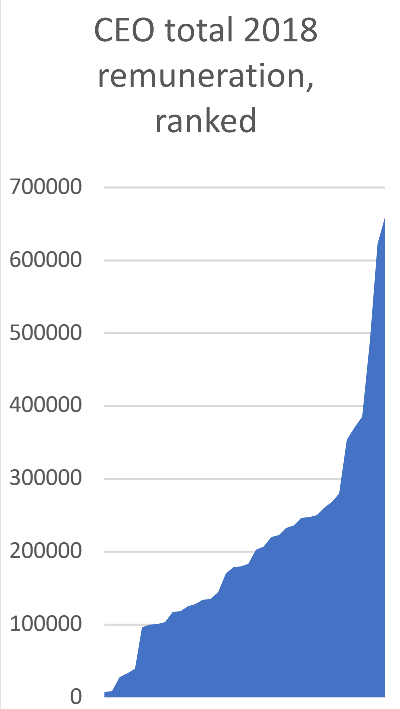
Board Remuneration

In recent years, we have commissioned a separate report on board remuneration, but the AFM Board concluded this year that this would not be provided, given the challenges of providing comparable data, and the reality than in most cases, AFM members are looking at remuneration comparisons in the wider insurance market and/ or in the local economy. We have however provided some brief observations, based on data submitted in the Code compliance questionnaire.

The charts below show CEO pay in 2018 (note that basic pay has been annualised for CEOs starting during the year). On average, 44% of organisations provided discretionary bonus arrangements for executives, and only 13% of CEO remuneration was made up on bonuses in the year, reiterating earlier comments that performance related pay is not a key factor in many organisations. Total remuneration (right hand chart) varies from under £10,000 (for a part-time role in a non-directive) to over £600,000.



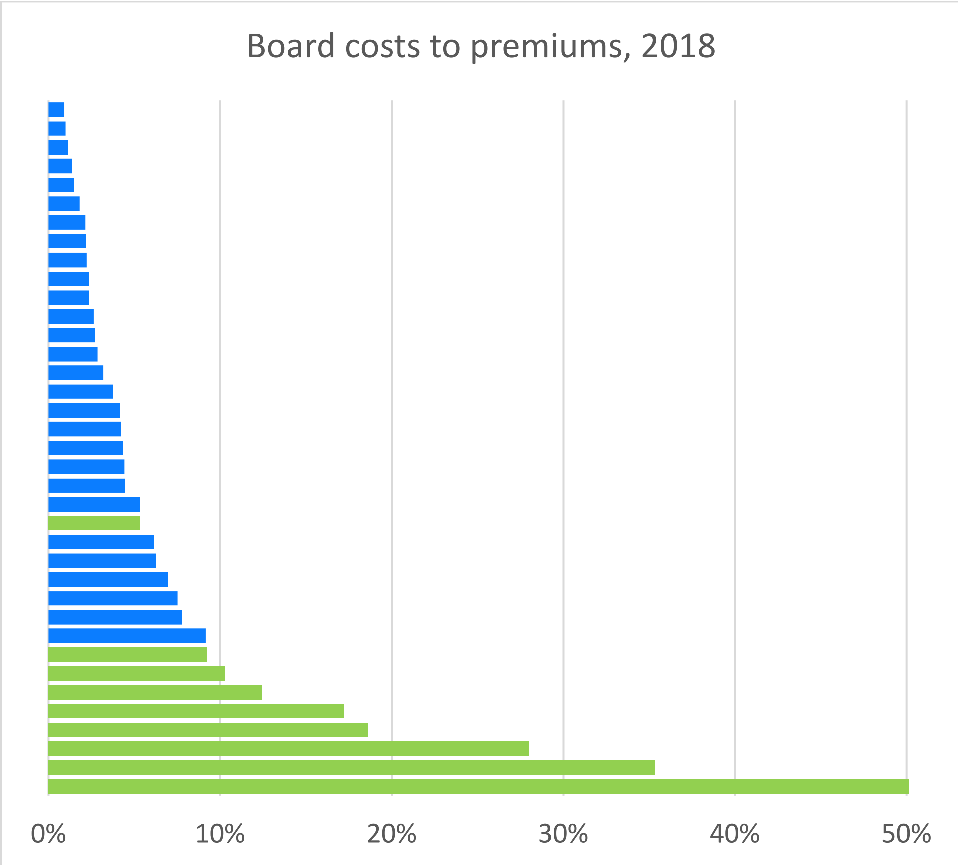
	all- average	non-directives	directives	all- median
Basic salary	£166,720	£66,980	£198,780	£145,157
Pension contribution	£16,335	£10,004	£17,977	£11,411
Other benefits	£16,099	£4,373	£18,704	£8,474
Bonus 2018	£30,160	£4,021	£38,115	£1,833



The average basic pay of the second highest paid executive in 2018 was £109,000, with total remuneration of £151,000.

For Chairs, the average fee paid for the year was £31,300. Around half of those leading a non-directive Board were unremunerated, whilst for the remainder of non-directives, average fees were £14,000, rising to £35,300 for Chairs of directives.

The questionnaire also collected data on total board costs. Whilst the data presented varied across organisations, a total of just over £20 million was reported, at an average of £550,000 per Board. The chart below demonstrates total board remuneration as a proportion of gross premium income for 37 organisations that supplied data.



On average, board remuneration accounted for 2.4% of the premiums paid by each customer in the year, though for non-directives in particular, whilst the absolute cost of the board was generally low, this equated to a large portion of premiums are directed to compensating the board.

Diversity

This section looks at gender diversity in mutuals, from the perspective of board composition and the gender pay gap.

AFM members submitted data on the composition of the board, including the gender of directors. At the end of 2018, the average board consisted of 6.8 male and 2.0 female directors. That means 23% of all directors were women, and demonstrates rapid progress in recent years (against 20% in 2017 and 18% in 2016). Amongst executives, 19% were female (17% in 2017) and for NEDs, the figures were 24% (compared to 21% the previous year).

We also collected data on the gender pay gap, adopting the requirements for large organisations. As almost all AFM members fall below the government's reporting threshold, the data is presented in aggregate form, and in our own assessment is of limited value, given the limited workforce in each organisation.

A total of 22 members provided a return for this section of the report, compared to 18 in 2017. The main results show that the pay gap fell significantly in 2018:

	2017	2018
Average Mean Hourly Pay Gap	36%	24%
Highest Mean Hourly Pay Gap	55%	50%
Average Median Hourly Pay Gap	23%	18%
Highest Median Hourly Pay Gap	54%	51%
Average Mean Bonus Pay Gap	32%	26%
Proportion of males receiving a bonus in 2017	71%	59%
Proportion of females receiving a bonus in 2017	73%	61%

According to AFM Associate member Willis Towers Watson, the financial services sector as a whole has a mean hourly pay gap of 27%, so the sector now sits below that, though it is not clear from the reports what has contributed to this dramatic improvement. Whilst 89% of the organisations in the sample indicated that female employees made up 50% or more of the lowest quartile of staff ranked by pay, 27% indicated more than half of the best paid staff are female.

Conclusions

This is our final report against a comply or explain format. In the future AFM members will be asked to 'apply and explain' the new AFM code, which covers six broad principles for good corporate governance, and it will not be possible to replicate this style of report under the way organisations will report against those principles.

With that context, this year's report sets out the continuing commitment of mutuals to maintaining high standards, even where those standards emanate from a listed companies' perspective and have been shown to provide a poor fit with the model of this sector.

That five out of six provisions were complied with across the sector is a source of great reassurance, though it does leave some perennial opportunities for improvement for some:

- The length of tenure, and independence of NEDs in some boards;
- The value to members of their board;
- The clarity of accountability of the board;
- The usefulness of the report and accounts in explaining how the business operates in the best interest of customers.

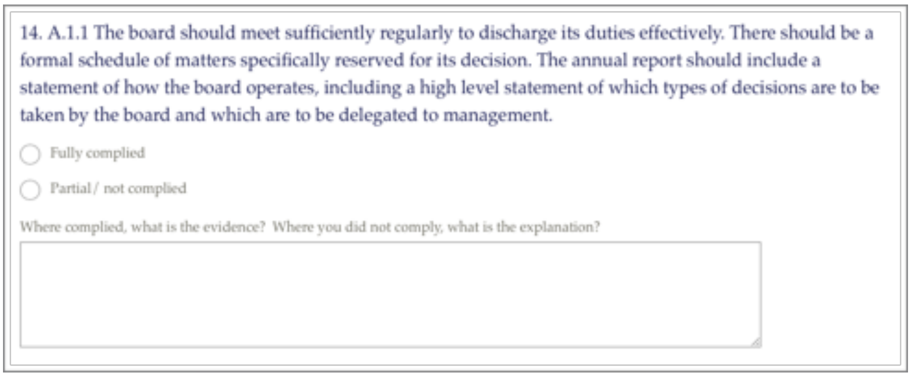
Annex 1: Methodology

The Annotated Code was developed in 2005 following the publication of the Myners' Review in December 2004, which made a specific recommendation for the introduction of a version of the Combined Code for the mutual life insurers.

At the time HM Treasury and the Financial Services Authority agreed that responsibility for producing the Code and detailed guidance for their members on its implementation would rest with the predecessors of AFM. The approach was reviewed post-launch by FSA, who were broadly content with the self-regulatory approach.

Within each section there are a number of Main Principles (27 in total across the Code), and a series of Code Provisions (of which there are 54 in total).

Members are responsible for evaluating their own compliance with the Code and for completion of a questionnaire, which gives detailed information about their compliance. The exercise was conducted again this year via Survey Monkey, and consists of a number of sections, with overview information of the organisation, data on the composition of the Board, director remuneration and gender pay, and a breakdown of compliance with each Code provision, as illustrated below:


14. A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.

Fully complied

Partial / not complied

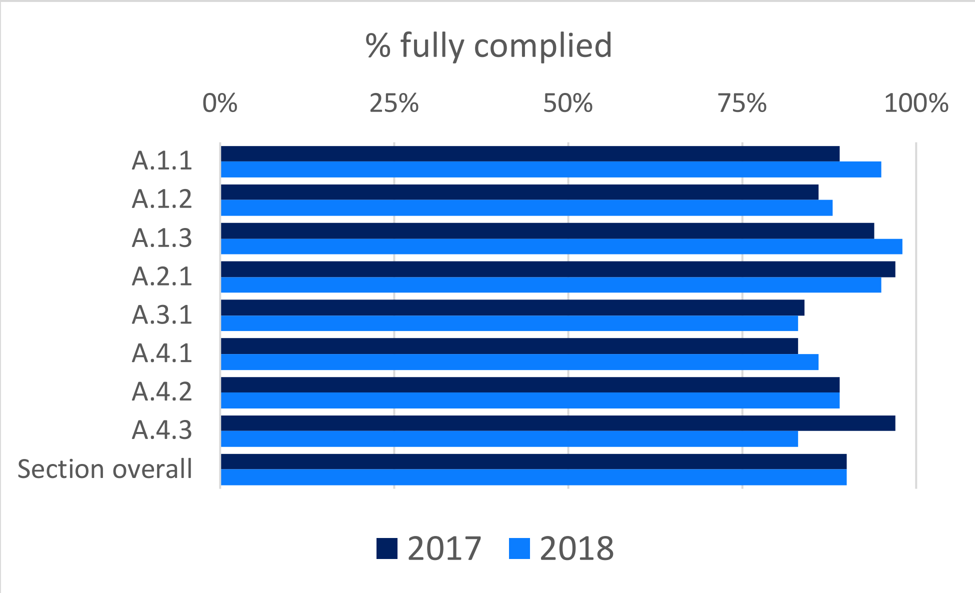
Where complied, what is the evidence? Where you did not comply, what is the explanation?

In completing this report, AFM has relied upon the information provided by members and has not attempted to validate or evaluate the submissions. It is also an expectation of our approach that individual companies report their compliance with the Code within their Annual Report and Accounts. Some elements of the Code are subject to review by the company's auditors.

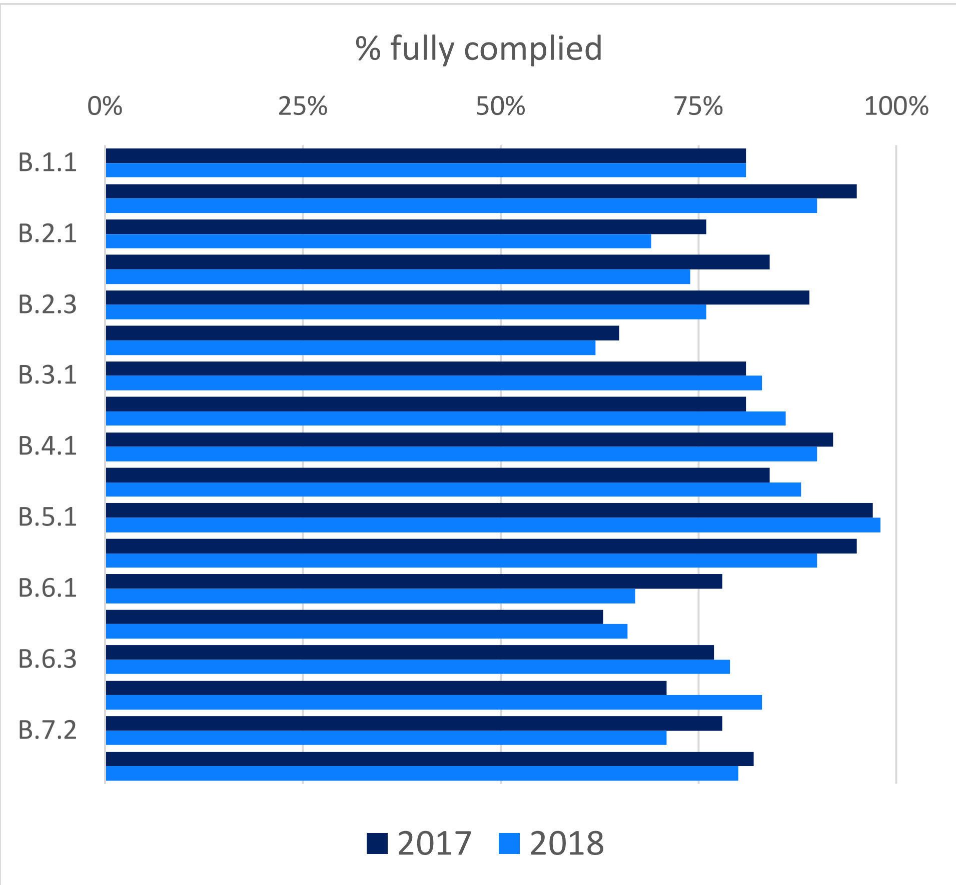
The Annotated Code recognises differences in regulation for non-directive societies (those that fall outside the scope of Solvency 2): some of the Code compliance requirements are voluntary for non-directives. We also provided some exemptions for not-for-profit organisations, where the provisions do not apply to their business model.

Annex 2: Breakdown of compliance in each section

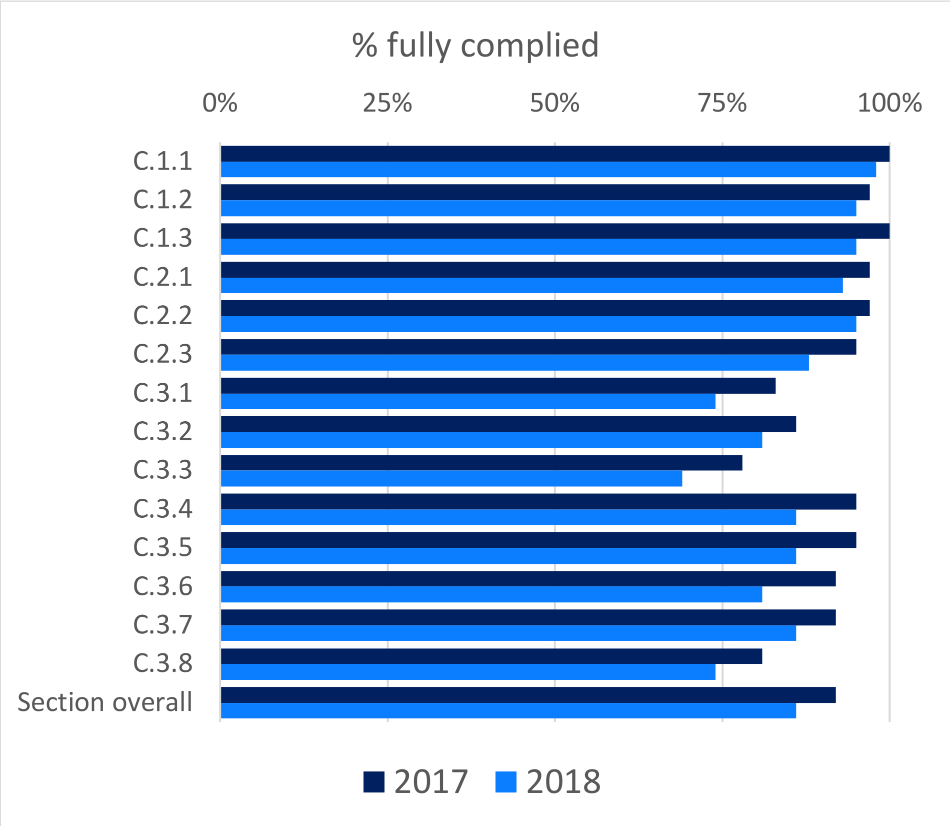
Section A: Leadership



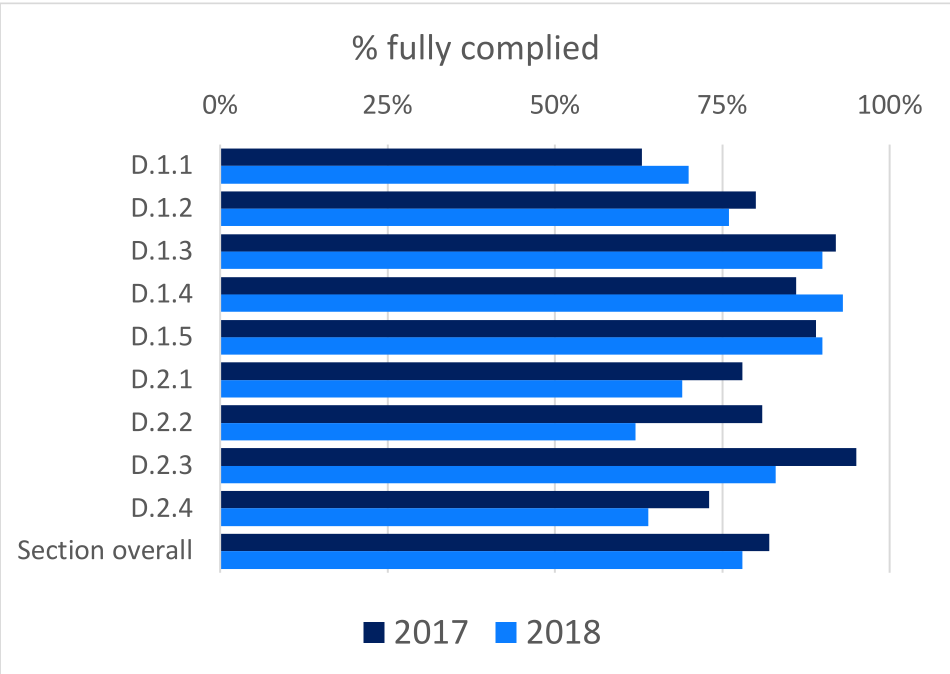
Section B: Effectiveness



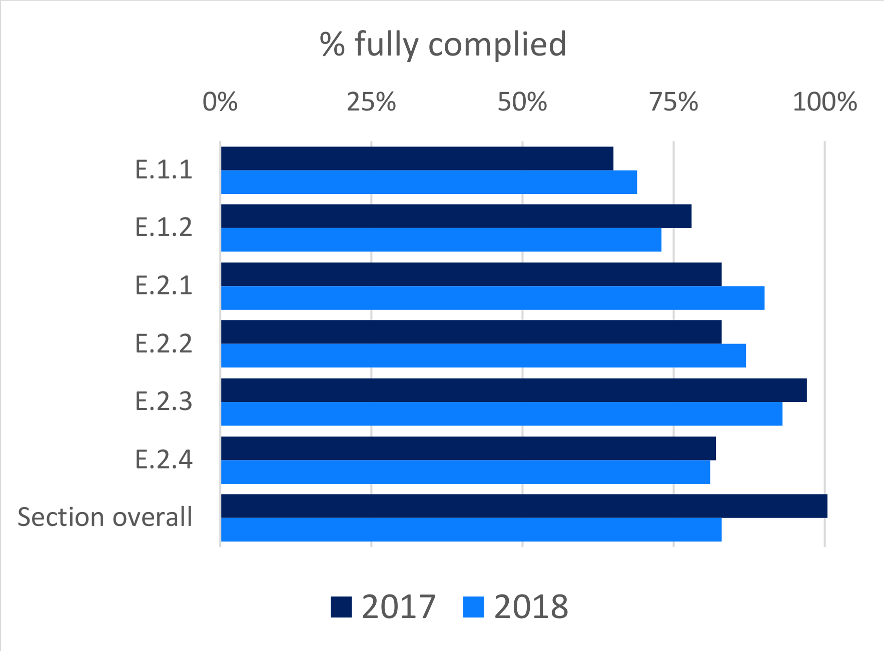
Section C: Accountability



Section D: Remuneration



Section E: Relations with members



Annex 3: Companies that took part in the 2017 compliance exercise

We restrict this Code compliance exercise to those of our members who are authorised and regulated by the Prudential Regulatory Authority and/ or the Financial Conduct Authority, and who have retail customers (by which we mean individual policyholders, named on an insurance contract or account).

We excuse members with no retail customers, members in their first full year of membership, and those that abide by comparable codes.

This year, all 42 relevant members completed the compliance exercise:

Anglo Saxons Friendly Society	Plutus Health
BHSF	Railway Enginemen's Assurance Society Limited
British Friendly Society	Red Rose Friendly Society
Bus Employees' Friendly Society	Scottish Friendly Assurance Society Limited
Cirencester Friendly Society Limited	Sheffield Mutual Friendly Society
Civil Service Healthcare Society Limited	Sovereign Health Care
Compass Friendly Society Limited	Tees Mutual
Cornish Mutual Assurance	The Ancient Order of Foresters Friendly Society Limited
Dentists' Provident Society ltd	The Benenden Healthcare Society Limited
dg mutual	The Independent Order of Oddfellows Manchester Unity Friendly Society
Exeter Friendly Society	The Medical and Dental Defence Union of Scotland (MDDUS)
Grand United Order of Oddfellows Friendly Society	The Original Holloway Friendly Society Limited
Health Shield Friendly Society Ltd	The Rechabite Friendly Society Limited trading as Healthy Investment
HSF Health Plan Ltd	The Shepherds Friendly Society Limited
Kingston unity Friendly Society Limited	Transport Friendly Society Limited
Lady Grover's Hospital Fund for Nurses	UIA (Insurance) Ltd
Medicash Health Benefits Limited	Veterinary Defence Society Limited
Metropolitan Police Friendly Society Limited	Welsh Hospitals & Health Services Association
National Deposit Friendly Society Limited	Westfield Contributory Health Scheme Ltd
Paycare	Wiltshire Friendly Society Limited
Pharmaceutical and General Provident Society	Worcester Hospital Contributors Association

Association of Financial Mutuals
7 Castle Hill
Caistor
Lincolnshire
LN7 6QL

www.financialmutuals.org